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ZNR UUUUU ZZH
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FM AMEMBASSY BUENOS AIRES
TO RUEHC/SECSTATE WASHDC 9427
INFO RUCNMRC/WESTERN HEMISPHERIC AFFAIRS DIPL POSTS
RUEHSO/AMCONSUL SAO PAULO 3562
RUEAIIA/CIA WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/USDOC WASHINGTON DC

UNCLAS SECTION 01 OF 04 BUENOS AIRES 001995

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PASS EXIM BANK FOR MICHELE WILKINS
PASS OPIC FOR JOHN SIMON, GEORGE SCHULTZ, RUH ANN NICASTRI
USDOC FOR 4322/ITA/MAC/OLAC/PEACHER

E.O. 12958: N/A
TAGS: EFIN ECON ETRD AR
SUBJECT: ELECTION-YEAR SPENDING EXTRAVAGANZA UNDERMINES
ARGENTINA'S FISCAL BALANCE AND ABETS HIGHER INFLATION

REF: BUENOS AIRES 1415

BUENOS AIR 00001995 001.2 OF 004

Summary

¶1. (SBU) Argentine President Kirchner's election-year spending spree has exceeded expectations and led to deteriorating fiscal accounts in 2007. Through July 2007, expenditures increased almost 50% year-over-year, a result of large increases in pension payments, subsidies, wages, and capital spending, all with the apparent goal of buying votes for the October 28 national elections. Estimates for the 2007 federal primary fiscal surplus (before debt interest payments) are a seemingly healthy 3.1 - 3.5% of GDP. However, the figure is only closer to 2% after subtracting a one-time transfer to the GoA from the private pension system. The provinces, in general, are in worse financial shape, and will likely require greater federal financial support. Maintaining current spending levels would risk fiscal deficits and increasing inflation starting in 2008, and would also threaten economic growth and the GoA's capacity to make debt payments. However, there is still time to make corrections, and Presidential front-runner Cristina Kirchner appears to realize that fiscal reform is the top priority for the next administration. End Summary.

Intro: Deteriorating Fiscal Erodes Macro Anchor
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¶2. (SBU) The GoA's rapid increase in election-year spending has resulted in deteriorating fiscal accounts in 2007, despite record revenues. The GoA's fiscal policy is pro-cyclical and extremely expansive, contributing to a consumption-led economic boom and boosting projected inflation up from under 10% in 2006 to the 15-18% (or higher) range in 2007, as estimated by numerous private economists. The GoA's adjusted official inflation number remains below 9%. In light of the Central Bank's expansionary monetary policy since 2005, the fiscal surplus has been the GoA's macroeconomic anchor. This anchor has eroded as a consequence of the Kirchner administration's spending

policies in 2006 and 2007. The apparent goal of these policies has been to gain political support for a string of elections this year, culminating in the October 28 presidential and legislative elections.

Expenditures getting out of control

¶3. (SBU) Private analysts' estimates and predictions on GoA expenditures vary widely, mainly due to the difficulty in obtaining reliable statistics, particularly on GoA subsidies. A senior Economy Ministry official, who is nominally in charge of budget issues, has admitted to Econoffs that the GoA has increased expenditure so rapidly in 2007 that total spending is a "moving target."

¶4. (SBU) Expenditures through July 2007 have increased an estimated 50% y-o-y. This was the result of election-year largesse, particularly increases in pension payments of up to 60% y-o-y. These payment increases were mainly due to a 13% increase implemented January 2007 and a 12.5% increase granted in September. However, they were also the result of the addition of more pensioners following the GoA's pension system reform (see paras 9-10 below). The GoA has also granted large increases in public wages (up almost 30% y-o-y) and transfers (subsidies) to the private sector, mainly for transport and energy (up at least 46% y-o-y, if not more). Capital spending has also increased rapidly (37% y-o-y), albeit at a slower pace than the 65% increase in 2006. Overall, federal primary spending (not including interest payments on debt) increased from 13.8% of GDP in 2006 to an estimated 17% of GDP for 2007.

Cost of Price Controls: Subsidies and Capital Spending
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¶5. (SBU) In order to alleviate pressure on those private sector companies whose products are subject to GoA price control policies, the GoA has steadily increased transfers to

the private sector as well as public sector capital expenditures. Both the subsidies and public works expenditures have been targeted primarily to the energy and transport sectors, where price controls in place since 2002 have resulted in supply shortages (due to lack of investment in infrastructure and maintenance -- see reftel).

¶6. (SBU) Private sector economists estimate 2007 public transfers at between 11 and 13 billion pesos (roughly $3.5 - $4.1 billion), or about 1.5% of GDP (compared to subsidies of 0.7% of GDP in 2006). This constitutes a more than 100% increase over such spending in 2006, which itself represented a more than 80% increase over subsidies/loans in 2005.

¶7. (SBU) The purpose of the transfers is to compensate for the difference in the international price of diesel and natural gas and the controlled and much lower domestic prices. The GoA is reportedly also directing a hefty percentage to subsidize fuel costs in the transport sector (trains, buses, subways, and air traffic). Of the total, roughly one billion pesos support agriculture and livestock.

Revenues growing, but at a slower pace

¶8. (SBU) Tax revenues increased over 38% y-o-y through July. Although the higher revenues are partly a result of improved compliance, they are largely due to high growth and inflation, with nominal GDP growth in the range of 24-26%. In addition, export taxes on Argentina's rapidly-growing primary commodity exports are responsible for about a third of the increase. Note, however, that the GoA recently announced another pre-election gift to voters, increasing the non-taxable annual income level that individuals can claim, resulting in a 1.5 billion peso reduction in income tax revenue. The purpose of this alteration to the tax code appears to be to pump up consumer spending prior to the October 28 elections (Comment: it will also likely pump up

inflation.)

¶9. (SBU) Through the end of July, total revenues -- including non-tax revenues -- increased approximately 55% y-o-y. However, non-tax revenues include one-off transfers to the GoA from the private pension system (see next section). This is a consequence of pension reform in early 2007, which allowed contributors to switch from the private system to the government pension plan.

Falling Primary Fiscal Surplus

¶10. (SBU) Private analysts estimate the 2007 federal primary fiscal surplus in the range of 3.1 - 3.5% of GDP. While this approximates the 3.5% primary surplus in 2006, and may still appear healthy, the figure is distorted because of the one-off pensions transfer. Subtracting this estimated $2.4 billion transfer to the GoA from the private pension system results in a federal primary surplus of only 2 - 2.4% of GDP, well below the 3.5% or higher level of 2004-2006.

¶11. (SBU) Private estimates of the overall federal fiscal surplus (including interest payments on debt) also vary widely, but are generally in the range of 1% to 1.5% of GDP, significantly below the over 2.5% peak in 2004. Note, however, that the overall federal fiscal surplus approaches a zero balance when excluding the one-off pension funds transfer.

Provincial Finances Also Deteriorating

¶12. (SBU) Taken as a whole, the Provinces' financial condition is worsening, although Buenos Aires Province and City, comprising over a third of total non-federal expenditures, are in the worst shape and skew the numbers. Through July, provincial revenues increased 20% y-o-y, compared to a 25% y-o-y increase in expenditures. Increases in provincial expenditures have exceeded increases in revenues every year since 2005. This is mainly due to rapid increases in salaries, which represent almost 50% of total provincial expenditures, compared to below 20% for the federal government (the Provinces have historically used public sector employment as a source of political patronage). As a result, for the first time since the 2002 crisis,

provincial primary spending may exceed total tax revenues in ¶2007. A likely consequence will be increased demands on the GoA for financial support to the provinces; payments that are not included in the above budget calculations.

¶13. (SBU) Some Argentine economists' predict the provinces will end 2007 with a slight primary fiscal deficit (of up to 0.2% of GDP), while others expect a tiny surplus, of 0.3% of GDP or smaller. However, all economists surveyed for this report expect an overall provincial fiscal deficit, when including interest payments on debt, of between 0.1 and 0.4% of GDP. This is a large turnaround from 2004, when the provinces' overall surplus exceeded 1% of GDP.

Consolidated Surplus Disappearing

¶14. (SBU) As a consequence of the deteriorated federal and provincial finances, the consolidated primary fiscal surplus (including federal and province governments) has fallen dramatically from its peak of 5.2% in 2004. Including the one-off pension system transfer, estimates for the 2007 consolidated primary fiscal surplus vary from 2.8% to 3.5% of GDP, and estimates for the overall consolidated surplus (including interest payments on debt) vary around 1% of GDP. However, a key point is that when excluding the pensions transfer, the consolidated fiscal balance (including interest payments) may end the year in deficit, for the first time since 2002.

Large Primary Surplus Needed to Ensure Debt Sustainability

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¶15. (SBU) Maintaining a large overall surplus is especially relevant to Argentina, given its current and contingent debt liabilities. Most analysts estimate Argentina's financing needs for 2008 at approximately $6-7 billion. Argentina can manage this debt, even taking into account the GoA's reduced access to capital markets following international financial market volatility that began in July. It can raise sufficient funds from Treasury savings, the government pension fund agency, and borrowing from the Central Bank. However, its financing needs will surge in 2009 and beyond, which may complicate the GoA's fulfillment of its financial needs.

¶16. (SBU) In addition to its normal financial needs, the GoA faces significant debt arrears and contingent liabilities. The GoA is facing roughly $6 billion in debt (including current arrears of about $4 billion) to Paris Club members, has approximately $25 billion in outstanding debts to so-called "holdouts," bondholders that did not participate in the 2005 debt exchange, and also has roughly $13 billion in outstanding claims before ICSID, dating to the 2001/2 financial crisis. In addition, in 2007 the GoA has announced about $14 billion in government-financed infrastructure projects over the next 2-3 years, mainly in the energy sector. While these payments will likely be negotiated down and spread over years, clearly higher fiscal surpluses are a requisite for the GoA to manage these contingent debts and finance the envisioned projects. Another important consideration, given the tight credit market, is that every percentage point of higher fiscal surplus is equivalent to $2.5 billion fewer funds that the GoA must raise in the market.

2008 Scenario: Slower Spending or Fiscal Unravels
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¶17. (SBU) In addition to undermining fiscal accounts and boosting consumer prices, the GoA's heavy spending has also contributed to the disproportionate impact of recent international market volatility on Argentina's country risk premium. Bondholders punished the GoA for undermining macro fundamentals and losing control of inflation. Therefore, local economists surveyed for this report argue that fiscal reform (reducing the pace of expenditures) is the critical task for the next administration, in order to regain credibility and reduce inflationary pressures. Otherwise, maintaining current spending levels will result in an overall consolidated fiscal deficit in 2008 and worsening deficits and inflation in 2009-2011.

¶18. (SBU) The good news is that a large chunk of the increase

in 2007 expenditures has a one-time impact, and will not necessarily carry over into 2008. This includes a substantial percentage of the increase in pension payments, and also includes subsidies to the private sector. In fact, Economy Ministry officials privately point out that cutting subsidies is the only feasible means to restore the fiscal balance to near 2004-2006 levels.

¶19. (SBU) GoA officials appear to have grasped that the deteriorating fiscal situation adversely affects Argentina's economic and inflationary outlook and the GoA's ability to raise financing. President Kirchner has reportedly ordered a reduced pace of spending following the October 28 elections and in the 2008 budget (septel). Economy Ministry officials tell us that they are instructed to pursue the "Kirchner Rule," which requires expenditures to increase at the same rate of growth as revenues. Senator and leading Presidential Candidate Cristina Fernandez de Kirchner has also publicly voiced concern about the GoA's deteriorating fiscal balance, and has pledged that as President she would pursue tighter fiscal policies in 2008.

Comment

¶20. (SBU) Argentina's ability to prevent this year's spending spree from precipitating an economic crisis down the road will depend on the next government's willingness to make quick policy adjustments. However, cutting subsidies would have major political ramifications for an incoming administration, as the GoA would likely be compelled to raise energy and transport tariffs to compensate private companies for the lost subsidies (and thus avoid severe supply problems). These higher prices would accompany slowing growth, surely an unpopular combination for the Argentine public. The Kirchners have yet to govern during a period of slowing growth, and it remains to be seen whether the new president will be willing to make the politically unpopular decisions necessary to bring down both inflation and growth to more moderate and sustainable levels. End Comment.
WAYNE